STATE OF CALIFORNIA

CALIFORNIA TAX CREDIT ALLOCATION COMMITTEE
915 CAPITOL MALL, ROOM 485
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MEMORANDUM

DATE: April 5, 2006

TO: All Interested Parties

FROM: William Pavão, Executive Director

SUBJECT: Augmentation of Existing Tax Credit Projects

This memorandum is in response to the Committee's request for TCAC staff to research how other states handle augmentation of existing tax credit awards. Staff has examined the augmentation policies of other states, as well as the 9% tax credit allocation protocols of those states. This memo contains those findings.

You may provide TCAC written comment concerning these findings and staff's analysis, by 4:00 p.m., Friday, April 14, 2006. You may also attend the next TCAC Committee meeting on April 19, 2006, at 1:00 p.m., and provide your comments during the public comment period. If you have any questions regarding this survey, please contact Elaine Johnson at (916)-653-4186.

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William J. Pavão
Executive Director

MEMBERS:
Philip Angelides, Chair
State Treasurer

Michael C. Genest,
Director, *Department of finance*

Steve Westly
State Controller

DATE: April 5, 2006

TO: Tax Credit Allocation Committee Members

FROM: William Pavão, Executive Director

SUBJECT: Augmentation of Existing Tax Credit Awards

Background

A. Historical Oversubscription of Nine Percent (9%) Tax Credits

California's 9% tax credit program has been one of the most oversubscribed in the country. In 2005, affordable housing developers requested $123 million in 9% tax credits. The Tax Credit Allocation Committee (TCAC) awarded $62.4 million. TCAC competitively awards applications for 9% tax credits, and many project applications, both successful and unsuccessful, attain perfect competitive scores. Among other things, competitive points are awarded for applicants effectively reducing the amount of credit requested by reducing the project's qualified basis[1] (Reg. Section 10325(c)(1)(B)). Applicants must reduce a project's qualified basis by at least two percent (2%) for the application to receive full points. Additionally, TCAC's third and final tiebreaker in awarding 9% tax credits is a ratio of the unadjusted eligible basis to total relevant project costs, with the project application that has the lowest ratio given preference in awarding credits. In essence, this tiebreaker rewards applicants for keeping the project's basis, and ultimately the credits requested, down relative to the projects costs.

B. Awards of 9% and 4% Tax Credits

Two types of federal tax credit projects are (1) those receiving competitive 9% tax credits, and (2) those receiving non-competitive four percent (4%) tax credits along with an allocation of tax-exempt bonds from the California Debt Limit Allocation Committee (CDLAC). While the amount of tax-exempt bond authority and 9% tax credits annually available to the state is limited under federal law, 4% tax credits are not. To be awarded 4% tax credits, an application must meet basic CDLAC and TCAC threshold criteria. Tax credits are reserved and awarded in three stages: a preliminary reservation; a final reservation; and a placed-in-service award.

[1] Qualified basis is the amount upon which the tax credit award is calculated.

Unlike the 4% tax credit program, the 9% tax credit program is federally capped annually by a per-capita formula. Consequently, the amount of 9% tax credits requested at final reservation and placed-in-service cannot exceed the amount awarded at preliminary reservation. TCAC handles remedies to development budget shortfalls differently for 9% versus 4% applications. The current regulations allow successful 9% applicants with shortfalls to return awarded credits and re-apply for a larger allocation in a subsequent round. In keeping with the competitive nature of the 9% program, the reapplication competes anew with the other applications. Regulation Section 10322(j) states that:

> For all other (nine percent) projects, except in unusual, extreme cases such as fire, or act of God, where a waiver of this subsection is permitted by the Executive Director, a re-application for a development that has already received a Tax Credit reservation or allocation shall be evaluated as an entirely new application, and shall be required to return its previously reserved or allocated Tax Credits prior to or simultaneously with its new application. All re-applications shall be subject to negative points under Section 10325(c)(3) if applicable (for example, a project that does not meet the original placed-in-service deadline would receive negative points hereunder). Re-applications shall be subject to the regulations in effect at the time the re-application is submitted.

Applicants awarded 4% tax credits may augment their initial tax credit allocation at placed-in-service without reapplying. Only if the project has experienced substantial changes, or if the sponsor requests an extraordinary increase in credits must an applicant reapply. Regulations provide that "substantial changes" or "extraordinary increases" include development cost increases exceeding 20 percent, or credit increases exceeding 15 percent.

C. Augmentation Issue History in California

In 2005, several affordable housing developers approached TCAC requesting an augmentation of 2002 and 2003 9% tax credit awards due to unanticipated cost overruns. Because construction was underway, the developers could not surrender their existing tax credit allocation and re-compete for a larger allocation in the next round. Therefore, they requested the Committee take the unprecedented step of augmenting 9% allocations outside of a funding round. After months of consideration, the Committee declined to change the current system in offering supplemental credits for projects awarded credits in 2002 through 2005. However, the Committee asked TCAC staff to research how other states treat augmentation requests.

D. Demand and Scoring Policies of Other States

Thirteen (13) states, in addition to California, do not augment initial 9% tax credit awards. Most of these states have strong demand for those tax credits, and include: Arkansas (oversubscribed 2:1); Indiana (oversubscribed 2.5:1); Iowa (oversubscribed 2.5:1); Oklahoma (oversubscribed 2:1); South Carolina and Tennessee (each oversubscribed 2.6:1).

States that have 9% tax credit programs with competitive scoring based on cost efficiency and efficient tax credit use (like California) include Arizona, Indiana, Michigan, New York and

North Carolina. Of those states whose scoring is most like California's, three (New York, Indiana, North Carolina) do not allow augmentation to initial tax credit allocations; one (Michigan) has a competitive re-application process; and one (Arizona) has a non-competitive process using the Executive Director's discretion. The majority of high-demand states with competitive scoring processes similar to California's do not allow augmentation.

Thirty-six (36) states allow augmentation of an initial 9% tax credit allocation. Among those are two broad categories: (1) States that require a competitive re-application process, and (2) those that augment in a non-competitive manner at the Director's discretion. Generally, the more oversubscribed states require competitive re-application for the supplemental credits. States that are undersubscribed or nominally oversubscribed generally have a non-competitive process.

E. Competitive Re-Application Process States

The following section outlines staff's review of several states with competitive re-application processes. Staff reviewed the demand for credits (the "Subscription Rate"); the process for augmentation awards (the "Application Process"); the amount by which a project may be augmented (the "Project Augmentation Limits"); the aggregate amount of credit available to projects seeking an augmentation (the "Augmentation Credit Availability"); and any other relevant limitations (the "Further Limitations").

- **Michigan**

Subscription Rate:	4:1
Application Process:	• Applications for additional credit may be submitted in any competitive funding round. • Additionally, to the extent that credits are available after October 1 in any year, Reservations and Carryover Allocations may be awarded at the agency's discretion. • For discretionary awards, a special panel must make a funding recommendation to the Executive Director.
Per Project Augmentation Limits:	• There is no limit on the increase that can be awarded to a project.
Augmentation Credit Availability:	• No special limits.
Further Limitations:	• Once awarded credits, additional credit requests may not change the tenant income-level configuration unless the change is to reach more low-income tenants, lower-income tenants, or both. • Augmentation apps must be prior to the placed-in-service date.

- **Missouri**

Subscription Rate:	3:1
Application Process:	• Projects compete against all other projects.
Per Project Augmentation Limits:	• No special limitation on project augmentation amounts. • Total credits awarded may not exceed the agency's maximum award ($700,000) or cost reasonableness limits.
Augmentation Credit Availability:	• No special limits on the amount of credit available.
Further Limitations:	• Owners may apply for an increase in tax credit amounts in subsequent years if a development's eligible basis has increased. • Additional credits may be awarded if there are credits available and the agency is satisfied that the additional amount is necessary for the project's financial feasibility.

- **Ohio**

Subscription Rate:	3:1
Application Process:	• Projects compete against all other projects. • Applicants or owners with a prior allocation of tax credits may apply for additional credits if necessary for the project's continued financial feasibility.
Per Project Augmentation Limits:	• No special cap on the amount of credit available through an augmentation. However, a project may receive no more than $1 million in total annual 9% tax credits.
Augmentation Credit Availability:	• No special credit set-asides or limits for augmentations.
Further Limitations:	• Once placed-in-service, a project may receive additional credits only if more square footage and/or units have been added to the project. • The stat agency must approve any substantial project changes prior to the application deadline. • Augmentation applications must include timely documentation. • Owners must meet all 2006 Qualified Allocation Plan (QAP) requirements unless specifically waived by the agency. • The agency has the sole discretion to approve such requests on a case-by-case basis.

- **Pennsylvania**

Subscription Rate:	3:1
Application Process:	• Competitive within a special set-aside for projects applying in the year they will be placed in service. • The original selection criteria may not be altered, and the augmented project must be placed-in-service in the current year. Otherwise, a whole new regional set-aside application is required. • A development seeking additional tax credits from the Additional Tax Credits Set-Aside may not simultaneously seek a Regional Set-Aside award. • The agency may consider Applications under the Regional Set-Aside once the Additional Tax Credits Set-Aside is exhausted. Alternatively, they may reallocate tax credits to developments to be placed-in-service in the current year.
Per Project Augmentation Limits:	• No special limitations on credit requested.
Augmentation Credit Availability:	• A special five percent (5%) set-aside is available for developments with a prior year tax credit reservation, and that will be placed in service during, the current year.
Further Limitations:	• No selection criteria changes are allowed, nor are substantive changes to the proposed development. • Regardless of which source the applicant chooses (i.e. Regional Set-Aside or Additional Set-Aside), applicants may request additional tax credits no more than twice following the initial reservation.

- **New Mexico**

Subscription Rate:	2.5:1
Application Process:	• Projects compete against all other projects in a given round.
Per Project Augmentation Limits:	• Projects must adhere to the agency's cost limits in effect at the initial award.
Augmentation Credit Availability:	• No special limits for augmentations. • No project will receive an award in excess of 25% of that year's federal credit ceiling. • No single principal or related entities will receive allocations in excess of 40% of the annual federal credit ceiling.
Further Limitations:	• Only projects with increased hard construction costs may apply for additional tax credits prior to placed-in-service award. • Only one additional tax credit allocation per project. • Applications will be subject to the agency's evaluation process. • The applicant must demonstrate and document hardship.

- **Colorado**

Subscription Rate:	2:1
Process:	• Only if the requested augmentation exceeds $100,000 must the applicant compete with all other applications.
Per Project Augmentation Limits:	• No special limits for augmentations. • Final amount of requested basis cannot exceed the basis limit for the current year of allocation. • No more than $1,100,000 of the annual 9% federal credit will be reserved for any one development or any one applicant, or affiliate thereof.
Augmentation Credit Availability:	• None.
Further Limitations:	• None.

F. Non-competitive, Director's Discretion States:

The following section outlines staff's review of the same criteria with respect to several states with non-competitive re-application processes.

- **Alaska**

Subscription Rate:	1.5:1
Process:	• CEO's discretion; also a project can re-apply for the next cycle, but it would have to compete against all other projects.
Per Project Augmentation Limits:	• Enough to induce in no more equity than 50% of the project's total development cost. If subsequent credit pricing increases, applicant, the reservation is not reduced.
Augmentation Credit Availability:	• Recaptured or returned credits can sometimes be given to projects that were not funded fully in a round.
Further Limitations:	• None.

- **Kansas**

Subscription Rate:	<1:1
Process:	• Director's discretion. • Requests for additional allocations must be made prior to the placed-in-service allocation.
Per Project Augmentation Limits:	• No special limits.
Augmentation Credit Availability:	• No special limits.
Further Limitations:	• One of four specified criteria must be met: Additional costs due to (1) local government requirements, (2) unforeseen rehabilitation costs, (3) unanticipated safety issues affecting tenants, 4) a significant change in the project has become necessary. • Agency does <u>not</u> allow requests for additional credits simply because the construction costs were higher than anticipated.

- **Massachusetts**

Subscription Rate:	1.2:1
Process:	• Requests are considered case-by-case.
Per Project Augmentation Limits:	• Total credit awards are capped at $500,000 per project. • Projects may receive augmentations up to a total aggregate award of $1 million. • Requests for allocations in excess of one million will be considered. If insufficient demand for the credit in a given year, then the agency may exceed the $1 million per-project limit.
Augmentation Credit Availability:	• No special limits.
Further Limitations:	• Additional credit allocations are considered a last resort. In general, the agency tries to avoid using additional credits to close funding gaps and instead look to other sources such as state bond financing and/or other lenders who were originally part of the project's financing.

- **South Dakota**

Subscription Rate:	<1:1
Process:	• Director's discretion. • Applicant must submit a new non-competitive application prior to a placed-in-service award. • Projects not initially receiving a full reservation due to inadequate available tax credits or other administrative limits may also apply for additional credits in subsequent years
Per Project Augmentation Limits:	• No special limits.
Augmentation Credit Availability:	• No special limits.
Further Limitations:	• There must be development cost increases that resulted in an eligible basis increase. • Development cost increases must be from increased hard costs; agency pre-approved project redesign; changes in applicable codes; and other unforeseeable events. • Additional tax credits will not be awarded for increases in the developer's fee or consultant's fee.

- **Texas**

Subscription Rate:	<1:1
Process:	• Applicants may request more tax credits pursuant to cost certification at the placed-in-service stage.
Per Project Augmentation Limits:	• No more than $1.2 million in tax credits will be allocated to any development. • No more than $2 million of tax credits in any given Application Round shall be allocated to any applicant, developer, related party or guarantor.
Augmentation Credit Availability:	• No special limits.
Further Limitations:	• Applicants must submit additional documentation with the cost certification along with the placed-in-service application. • The agency re-underwrites the application, evaluating the requests and writing up their analysis and recommendation. • The Board at its sole discretion may award credits to an owner, in addition to those awarded at the time of the initial Carryover Allocation, for substantiated cost overruns. The agency must determine that the allocation will maintain the project's financial viability.

- **Utah**

Subscription Rate:	1.8:1
Process:	• Agency discretion. • All projects are initially over-reserved (reserved at 14%). • The state has a cost-increase set-aside
Per Project Augmentation Limits:	• No more than approximately 20% of the state's total annual tax credit ceiling amount may be reserved to any one project. Larger projects may be phase to accommodate a greater allocation of credits. • Should the State of Utah be at risk of losing Credits, the agency may allocate additional credits to a project(s), but still within the 20% ceiling.
Augmentation Credit Availability:	• No special limits.
Further Limitations:	• None.

G. Summary Analysis:

The states staff surveyed employ a variety of strategies when recipient projects incur cost overruns resulting in development funding gaps. Generally speaking, those states who have less demand for the 9% Low Income Housing Tax Credits are the most accommodating. By regulation, TCAC is similarly accommodating for noncompetitive 4% tax credit deals. That is, 4% tax credit recipients may typically seek a modest augmentation (less than 15%) administratively at the placed-in-service award stage.

California's 9% allocation process is quite different in that it is (a) dramatically oversubscribed[2], and (b) competitively driven with a heavy emphasis on tax credit usage efficiency. Therefore, any system that allows a back-end petition for additional credits jeopardizes the good public policy outcomes sought by the current scoring scheme. Good faith users of California's 9% system have candidly told staff that they would err on the side of understating estimated development costs if a readily-available augmentation mechanism existed. This is contrary to the credit-efficiency objectives we seek with our scoring.

Thirty percent (30%) of the States polled do not permit additional credits to augment prior awards. These states (including Florida, New York, Indiana, North Carolina, South Carolina) include states that have a high demand and similar scoring criteria. California has a significant, and at times very contentious, history developing the competitive system we have today. The California system attempts to accomplish a variety of good public policy outcomes including fairness in allocating a scarce resource and efficiency in how that resource is used. Introducing an augmentation feature beyond what we have in place today jeopardizes that tenuously balanced system.

[2] In 2005 California was oversubscribed 2:1, with much higher oversubscription ratios in prior years.

Finally, I would highlight that the TCAC's Executive Director currently has the regulatory authority to permit reapplication to augment 9% awards without the applicant returning the prior award "in unusual, extreme cases such as fire, or act of God" (Section 10322(j)). This accounts for the truly unexpected event that threatens the fiscal viability of the project that has gotten underway when disaster strikes. This provision provides adequate flexibility to allow an augmentation to rescue an otherwise successful development.

Attachment: Chart of 50 states summarizing their augmentation policy.
Note: "*" denotes that TCAC staff was unable to contact that state for information.

STATE	Augmentation Not Allowed	Augmentation: Competitive	Augmentation: Non-Competitive
Alabama		X	
Alaska			X
Arizona			X
Arkansas	X		
Colorado		X	
Connecticut		X	
Delaware			X
Florida	X		
Georgia		X	
Hawaii		X	
Idaho		X	
Illinois			X
Indiana	X		
Iowa	X		
Kansas			X
Kentucky		X	
Louisiana*			
Maine			X
Maryland			X
Massachusetts			X
Michigan		X	
Minnesota	X		
Mississippi*			
Missouri	X		
Montana	X		
Nebraska*			
Nevada		X	
New Hampshire		X	
New Jersey		X	
New Mexico		X	
New York	X		
North Carolina	X		
North Dakota		X	
Ohio		X	
Oklahoma	X		
Oregon		X	
Pennsylvania		X	
Rhode Island*			
South Carolina	X		
South Dakota			X
Tennessee	X		
Texas			X
Utah			X
Vermont			X
Virginia		X	
Washington	X		
West Virginia*			
Wisconsin		X	
Wyoming			X